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OUTLOOK

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THE MORALITY OF GOVERNMENT SPENDING

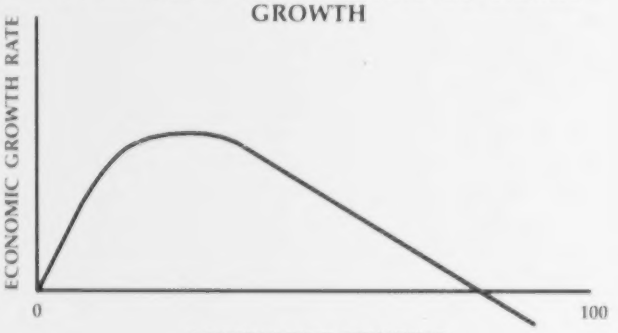
by
Richard W. Rahn

The warnings are already beginning to be heard: If government spending is reduced much further, we might precipitate a recession. In fact, some leading Democratic politicians are again muttering about the need to increase government spending to reduce poverty and unemployment. Such comments are not all that surprising, given that the last two generations have been taught that increased public spending can cure most of society's ills. This notion, echoed in the Catholic Bishops' recent pastoral letter on the U.S. economy, allows the advocates of bigger government to wear the moral mantle of superior compassion over their more fiscally conservative brethren.

Until now, calls for spending restraint have been predicated on a new and proper understanding that both high marginal tax rates and increased deficit financing reduce the economy's growth potential. However, the notion that government spending, in and of itself, may actually be destructive to economic prosperity has never been adequately challenged. In fact, only recently has the conventional wisdom begun to face some criticism. This is reflected in the fall from grace of Keynesian demand management policies, which argued that increased government spending would multiply itself through the economy to create higher levels of income. The same is happening in the area of development economics. Whereas in the past, the government was viewed as the initiator of economic development, there is today a growing realization that it was, in fact, central government planning in the development strategies of some LDCs, which has relegated many of these nations to perpetual misery.

But what if it were shown that increased government spending is destructive to greater prosperity? Then, the whole moral basis of the argument for increased government spending begins to shrivel away. In fact, the evidence is rapidly growing that beyond a certain point, increases in government spending (as a percentage of gross national product) becomes an economic hindrance; that is, additional spending is more likely to increase economic misery than to alleviate it. On the basis of this growing body of evidence and our observations of the effects of increases in government spending, we believe that the diagram in Figure 1 accurately represents the actual long-term effect of government spending on economic growth.

FIGURE 1
GOVERNMENT SPENDING AND ECONOMIC GROWTH



The first section of the graph shows that at zero or extremely low levels of government spending, economic growth is also low. Under conditions of anarchy, or the complete absence of a government sector, no progress can take place because public goods and services, essential for the proper functioning of markets, are not being provid-

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ed. Increases in government spending stimulate economic activity by providing those goods and services which facilitate market operation. A level of government spending sufficient to provide a judicial system encompassing basic protection of persons and property, adequate defense from foreign enemies, law and order, and fundamental "public goods" such as public health programs is necessary to provide the security required for people to work, save and invest. Sustained and rapid economic growth only takes place as a result of high levels of productive investment in both physical and human capital. Defense spending needs to be sufficiently high to give the majority of the citizenry the feeling of reasonable security about their own individual well-being and that of their property. U.S. defense spending, by providing a security umbrella for many of our allies and friends, encourages investment in many places outside the U.S., but in the long run, Americans also benefit from this increase in worldwide prosperity and security.

However, it is possible to reach a point where increases in the government's share of the economy no longer foster additional production and income. As the government sector begins to account for an ever larger share of total production, its positive contribution to aggregate economic activity begins to diminish. As it provides more and more goods and services, the public sector begins to compete directly with private sector providers. And since it also competes for the scarce resources available, the public sector effectively crowds out the private sector. Moreover, in many instances, public sector activities enjoy monopoly or quasi-monopoly powers not available to private suppliers. The end result, therefore, is that the economy's resources are inefficiently utilized and output gains are smaller.

At even higher levels of government spending, the public sector may actually have a negative impact on the economy by providing perverse incentives. For instance, many well-meaning social programs, largely those associated with income transfers and cash assistance, have such adverse effects on savings and labor supply that they discourage productive activity. Thus, their expansion would reduce, not increase, long run economic growth. Moreover, as the scale of government increases, it becomes increasingly necessary to raise taxes to pay for that ever-expanding supply of publicly produced goods. The negative effects of high taxes are, by now, a well established fact. Thus, the combination of high levels of government spending and the associated high tax burdens necessary to finance that spending are a powerful disincentive to productive economic activity.

Finally, in those few cases where there have been serious attempts at complete collectivization of the economy, such as Cuba in the early 1970s, or China during the "Great Leap Forward," the actual standard of living of the population declined for several years.

The diagram represents a greatly simplified statement of all of the economic forces at work. It is, of course, true that the point of diminishing GNP growth rates is not the same for all countries or consistent across all time periods. These variances do not, however, negate the validity of the general proposition.

Indeed, industrial country data for the past twenty years reflects this relationship. As Table 1 shows, average real GDP growth for the seven major industrial countries has declined steadily since 1965. Not coincidentally, the government share of GDP has risen just as steadily. This does not mean to imply that the increase in government spending is the only reason that economic growth declined, but we do believe it was a significant contributing factor. For instance, a recent cross sectional study of 30 countries by Barth, Keleher and Russek (July 1986) on the link between the size of government and economic growth shows a negative relationship in 27 cases, with 17 of those statistically significant.

TABLE 1

GOVERNMENT SPENDING AND GROWTH
SEVEN MAJOR OECD COUNTRIES
(Percent)

	Government Outlays as a % of GDP	GDP Growth Rate
1965–69	32.6%	5.0%
1970–74	33.4	3.6
1975–79	37.4	3.3
1980–84	41.2	1.8

Source: Organization for Economic Cooperation and Development

From the evidence, what can we conclude? First, a modest reduction in government spending will not cause a recession, but will enhance economic growth by reducing the government's claim on productive private economic activity. The exceptions to this would be if government programs which protect basic health and safety were reduced to an extent that the true economic costs suffered outweighed the spending reduction benefits, and if defense spending were reduced to put the country at risk.

Second, spending reduction can cause hardship to certain dependent citizens even though more citizens would be made better off because of the reduction. Hence,

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reasonable transitions or provisions in spending reduction programs are necessary to minimize undue hardship.

In sum, if a member of Congress is going to act as an economically responsible and moral individual, he or she must work to reduce aggregate government spending and to eliminate or modify those spending programs that cause more total misery than benefits.

THE SKY IS NOT FALLING

by
Graciela Testa-Ortiz

The American economy has entered its fifth year of uninterrupted growth. In fact, despite the worries of the Chicken Littles of the profession, the signals which usually presage recession are nowhere to be seen.

Historically, periods of economic expansion have ended when the economy reaches the limits of its productive capacity. The signals that presage the end of the expansion are rising interest rates, inflation, labor costs and capacity utilization rates. This time around, however, capacity utilization in the manufacturing sector remains substantially below the levels at which bottlenecks and supply interruptions would occur. Moreover, rather than increasing as the expansion progresses, as is usually the case, the rate of capacity utilization has been falling during the past two years. From the recession trough of 68.2 percent in the fourth quarter of 1982, it rose to a peak of 81.6 percent in the third quarter of 1984 and has been declining steadily since then, averaging 79.8 percent in the third quarter of this year.

Rising labor costs are another indication that the economy is facing constraints which can push it into recession. Unit labor costs have risen by only 3 percent since the second quarter of 1984. This has been an important factor in keeping inflation in check; the price level, as measured by the implicit GNP deflator, has increased by 13 percent since the end of the recession, compared to a 29 percent increase during the comparable period of the 1970s expansion. Measured on a year-ago basis, the rate of increase in the GNP deflator has been declining steadily since 1981. It is rising inflation during the later stages of recovery which prompts the monetary authorities to restrain the increases in the money supply, thus choking off the expansion.

Finally, during other expansions, as the economy continues to grow, the increased competition for loanable funds as well as rising inflationary expectations, put upward pressure on interest rates. Rising interest rates, in turn, depress activity in the interest-sensitive sectors such as housing and autos, and the decline in activity feeds through to the rest of the economy. This time around, however, not only have interest rates not risen, they have actually continued to decline. The three-month Treasury bill rate reached a peak of 10.3 percent during the third quarter of 1984 and has declined steadily since then, averaging 5.5 percent during the past quarter.

These developments notwithstanding, many analysts are calling for recession, or at least a slump, during the first half of 1987. According to these scenarios, the risk of recession arises from a combination of significant cutbacks in consumer spending and the effects of tax reform on the investment sector.

The mid-year surge in consumer spending, accompanied as it was by continued increases in the installment debt to income ratio and a sharp drop in the personal savings rate, have prompted many analysts to fear that the consumer is no longer in a position to continue supporting the expansion. These arguments are almost identical to those voiced at the end of 1985. During 1985, as is the case this year, consumer spending rose faster than the overall economy. In fact, the numbers are remarkably similar: real consumption increased by 3.5 percent in 1985 while gross national product rose by 2.7 percent; projections for 1986 place the consumer spending increase at 3.9 percent while GNP is anticipated to rise by 2.6 percent.

Then, as now, the increase in consumer spending was largely in durable goods consumption, and the bulk of that strength was accounted for by purchases of motor vehicles spurred by dealer incentives and below-market financing. Domestic car sales surged to 9.4 million units during the third quarter of last year; the story was repeated again this year as domestic car sales reached an annual rate of 9.7 million units during the third quarter, thanks to loan rates as low as 2 and 3 percent. Similarly, the ratio of consumer installment debt to disposable income was reaching new heights, and the savings rate had dipped substantially.

All of these developments are related. The below-market financing offered by auto dealers was a powerful incentive for consumers to buy new cars. As they did so, the savings rate declined and consumer installment credit outstanding surged. The personal savings rate fell by 2.5 percentage points between the second and third quarters of 1985 and then bounced back. The same pattern is being repeated this time around. The decline in the savings rate this year was of the same magnitude and, as of October, it had already risen from the third quarter's average of 3 percent to 3.5 percent.

This year's experience does differ from 1985, but in ways which tend to reinforce our optimism. On a month-to-month basis there does not seem to be any discerni-

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1988
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual			Forecast						Actual	Forecast		
	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4	88:1	1985	1986	1987	1988
GROSS NATIONAL PRODUCT													
Real GNP	3.8	0.6	2.9	2.9	2.6	3.0	3.7	4.2	3.3	2.7	2.6	3.0	3.2
Consumption	3.6	6.2	6.5	-1.6	2.7	2.4	2.7	2.1	2.3	3.5	3.9	2.5	2.4
Residential Investment	11.0	14.5	9.7	-10.4	-9.0	-3.2	5.1	7.5	1.3	3.9	8.3	-2.0	1.9
Nonresidential Investment	-15.1	-0.9	-0.1	0.7	2.1	2.6	5.5	5.9	5.7	9.3	-0.9	2.1	4.3
Equipment	-17.0	19.6	3.4	2.2	3.0	3.3	6.5	6.6	6.1	10.1	4.2	4.5	4.6
Structures	-10.8	-35.2	-8.2	-2.8	-0.1	0.8	2.8	4.0	4.7	7.7	-11.2	-3.7	3.6
Exports	7.1	-9.8	9.3	8.6	10.4	11.2	12.5	12.2	12.8	-2.0	1.6	9.1	9.8
Real Net Exports (82$B)	-125.9	-153.9	-163.6	-151.1	-142.3	-135.0	-130.1	-125.4	-118.6	-108.2	-148.6	-133.2	-113.9
Imports	0.2	15.8	14.7	-3.6	0.4	2.4	5.3	5.5	4.5	3.8	9.8	3.5	3.7
Government Purchases	-27.5	11.0	8.1	14.3	-13.8	0.1	7.3	16.5	-14.3	10.9	2.9	2.3	1.3
Final Sales	1.4	5.5	8.7	3.0	4.2	5.8	7.1	7.8	6.0	4.2	5.3	5.5	6.8
Change in Business Inventories (82$B)	39.9	15.1	-5.7	8.8	20.4	22.9	19.3	15.9	30.3	9.0	14.5	19.6	24.1
Industrial Production	-0.3	-2.9	2.3	2.4	2.6	3.7	4.8	6.4	3.9	2.6	0.5	2.9	3.8
New Car Sales (mill.)	10.6	11.2	13.2	10.4	10.0	10.7	10.8	11.2	11.0	11.2	11.4	10.7	11.0
Domestic Car Sales (mill.)	7.8	8.1	9.7	7.2	7.2	7.8	7.9	8.0	7.8	8.2	8.2	7.7	7.9
New Housing Starts (mill.)	1.99	1.91	1.75	1.65	1.56	1.61	1.66	1.68	1.63	1.74	1.83	1.63	1.65
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.1	7.2	6.9	7.0	7.1	7.0	6.9	6.6	6.5	7.2	7.0	6.9	6.5
Compensation	3.0	2.3	2.5	2.8	3.4	3.5	3.7	4.0	4.6	4.0	3.0	3.2	4.3
Productivity	4.3	0.4	0.2	1.6	0.6	1.4	1.8	1.9	1.1	0.5	1.0	1.1	1.3
Unit Labor Costs	-1.6	2.2	2.2	1.0	2.8	2.2	1.9	2.0	3.5	3.7	2.0	2.1	3.0
Consumer Price Index	1.4	-1.7	2.6	2.8	2.7	3.1	3.1	3.3	3.4	3.5	1.9	2.6	3.2
Implicit GNP Deflator	2.5	1.8	3.6	1.8	2.6	2.9	2.9	2.9	3.0	3.3	2.7	2.7	3.0
Prime Interest Rate (%)	9.4	8.6	7.9	7.5	7.3	7.1	6.8	6.7	6.7	9.9	8.3	7.0	7.1
3-mos. Treasury Bill Rate (%)	7.0	6.1	5.5	5.3	5.0	4.7	4.4	4.5	4.6	7.5	6.0	4.7	4.7
Corporate Bond Rate (%)	9.6	9.0	8.8	8.7	8.4	8.0	7.8	7.7	7.6	11.4	9.0	8.0	7.5
Real Personal Disposable Income	6.4	7.2	-2.6	1.4	4.7	1.1	1.6	1.4	6.0	1.4	3.2	2.0	2.5
Profits from Current Production ($B)[1]	207.3	199.9	202.2	189.6	172.5	172.5	179.3	188.1	199.8	189.0	199.7	178.1	200.6
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										736	769	835	925
Unified Outlays										937	990	1020	1090
Unified Deficit										-201	-221	-185	-165

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.
[2]Unified budget figures on a fiscal year basis. FY85 and FY86 data are actual.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the latest revisions to the National Income and Product Accounts for the third quarter of 1986. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 14.3 percent during 1986, 9.8 percent in 1987, and 6.3 percent during 1988. The trade weighted exchange value of the dollar falls by 16.3 percent in 1986, 3.0 percent in 1987, and 5.1 percent in 1988. The price of imported oil averages $14.00 per barrel in 1986 and $15.00 per barrel in 1987 and 1988. The federal minimum wage is not expected to increase.

ble pattern in the rate of growth of consumer installment credit outstanding. However, on a year-ago basis, the rate of increase in consumer credit outstanding has been slowing steadily for the past two years, despite the fact that it remains at double digit levels. Another fact that has not received much attention is that the delinquency rate on consumer installment loans, after reaching a peak in May and June, dropped sharply during the third quarter and is now at rates comparable to the lowest reached in 1985. Moreover, the Mortgage Bankers Association has just reported that the mortgage delinquency rate has fallen to its lowest level in two-and-a-half years.

Finally, three factors that we mentioned in November 1985 with regard to the consumer debt burden are worth repeating. Firstly, although debt burdens have increased, so has household net worth. Secondly, the debt to income ratio exaggerates the burden of debt because of the continued convenience use of credit cards. Surveys show that as many as half of the users of bank credit cards pay their bills in full every month. Estimates place the overstatement on the debt/income ratio resulting from this factor alone at about one percentage point. Thirdly, demographic trends are compatible with the increase in indebtedness that we are now witnessing. The life-cycle theory of consumer behavior holds that younger households borrow heavily to purchase homes and consumer durables. As the proportion of the population in the 25 to 44 age bracket rises, so does household indebtedness.

Nevertheless, there is reason to believe that the first half of 1987 will be weaker than the second half of that year. However, it must be emphasized that this in no way means that a slump or recession is in the making. Despite all the mitigating circumstances mentioned above, it remains a fact that the ratio of consumer debt to income has continued to reach new highs, and that the delinquency rate on consumer installment credit is significantly above the 1984 lows. However, much of the weakness during the first half of next year is likely to stem from the investment sector as a result of the effects of tax reform on both residential and nonresidential investment. Residential investment is anticipated to decline by 2 percent in 1987 while investment in nonresidential structures falls by 3.7 percent.

Despite the third quarter increase in the merchandise trade gap, we continue to expect that the foreign trade sector will become a net plus to the economy during the next two years. Real exports are expected to rise by 9.1 percent in 1987 and 9.8 percent in 1988, following a 2 percent decline in 1985 and an anticipated 1.6 percent increase this year. Real imports should increase by 3.5 percent and 3.7 percent in the next two years, respectively.

Some industries are already reporting significant increases in export orders. For example, orders for paperboard have risen by 18.5 percent, pharmaceuticals orders rose by 14.7 percent, and orders for electrical parts and metalworking machinery have both increased by 13.8 percent. The value of U.S. exports of agricultural products rose by 5 percent during the third quarter despite the fact that the overall increase in exports was insignificant. Moreover, exports of some commodities, such as wheat, cotton, rice and corn, have enjoyed very large increases. Although nonfarm exports were unchanged in the third quarter, most of this lackluster performance can be accounted for by a 48 percent drop in exports of nonmonetary gold, a reflection of the sharp increase in this category of exports during the second quarter when Japan was importing gold for minting commemorative coins. Exports of civilian aircraft to Brazil and Australia contributed to a 58 percent increase in this category of exports, while exports of business and scientific machinery and chemicals also contributed substantially to the rise in exports. On the import side, slower growth in consumer spending will reduce the demand for imported goods.

Our forecast for the next two years places the increase in real gross national product at 3.0 percent in 1987 and 3.2 percent in 1988. However, there are significant risks to the outlook. Tax reform has all but ensured that the investment sector will remain weak. While stronger growth is expected to resume after mid-1987, the increase in investment remains lackluster at best. As the article that follows explains, the treatment of capital gains should be improved to spur investment. But the risk that efforts to reduce the budget deficit may take the form of calls for tax increases is still very real. The recently elected Speaker of the House, Congressman Wright, has already suggested that the second stage of the reduction in personal income tax rates not be implemented as scheduled in 1988.

NEXT YEAR'S TAX BILL: FIX CAPITAL GAINS*

by
*Cesar V. Conda***

While the new tax reform bill should be a net plus to the overall economy in the long-run, several of its provisions – including the onerous tax treatment of capital gains – must be corrected. The bill's repeal of the Federal capital gains differentials for individuals and corporations will result in staggering increases in effective tax rates on

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capital gains. Increasing the capital gains tax will have a serious negative impact on investment and risk-taking, entrepreneurship, mobility of capital, international competitiveness and Federal tax revenues. Fixing capital gains should be the first order of business in next year's "Technical Corrections Act of 1987."

The One-Two Punch

Under the new tax code, the taxation of long-term capital gains will suffer from a "one-two" punch – first at the Federal level and again at the state level. On the Federal level, the 60 percent individual capital gains exclusion from ordinary income is repealed, raising the top federal capital gains tax rate from 20 to 28 percent. Capital gains tax rates in lower brackets will rise considerably more. For example, in the 1986 marginal tax bracket of 42 percent, capital gains are taxed at 16.8 percent, while the rate in 1987 rises to 28 percent and after that as high as 33 percent. Corporate capital gains will be taxed at the same rate as all other corporate income, with the maximum rate rising from 28 percent to 34 percent. Thus, individuals and corporations in the highest tax brackets will experience increases in federal capital gains taxes of 40 percent and 21 percent, respectively.

But to this must be added the effect of state income taxes. Most states conform their tax codes to the Federal tax base. Ending the Federal capital gains differentials will automatically require that the states do likewise. Consequently, if state income tax rates are not lowered, capital gains will be exposed to the maximum tax brackets. For most states, the effective tax rates on individual capital gains will rise from the 20 to 22 percent range to 36 to 37 percent (see Table 1). Similarly, the top effective tax rate on corporate capital gains will rise to the 39 to 40 percent range in most states.

Consider the plight of a New York state investor in the top income tax bracket. Under the old tax code, this investor paid an effective capital gains tax rate of only 22.7 percent (see Table 2). Under the new tax code, this tax rate rises sharply. The top Federal (28 percent) and state (9.72 percent) capital gains tax rates boost the effective tax rate to 37.72 percent – a 66 percent increase. For New York investors in the range of the phaseout of the 15 percent bracket and of the personal exemption (taxable income between $71,900 and $149,000 for joint filers and $43,150 and $89,560 for single individuals), the effective tax rates (33 percent Federal tax and 9.05 state tax) will rise to 42.05 percent after 1987 – a staggering 85 percent increase.

Moreover, elimination of the Federal differentials will result in a wide variation in effective capital gains tax rates from state to state. Today, the effective top tax rate on individual capital gains ranges from 20 percent in states with no capital gains tax to only 22 to 23 percent in high tax states. Tax reform would widen the rate variation between states from 28 percent to a theoretical high of 40 to 42 percent. As a consequence, wealthy individuals and corporations will have a powerful incentive to move to low tax states.

TABLE 1

MAXIMUM EFFECTIVE INDIVIDUAL CAPITAL GAINS TAX RATES*
(Adjusted for Effect of Federal Deductibility)

State	Highest State Bracket (%)	Effective Old Tax (%)	Effective New Tax (%)	Percentage Increase
New York	13.5	22.7	37.72	66.1
Iowa	13.0	22.6	37.36	65.3
West Virginia	13.0	22.6	37.36	65.3
California	11.0	22.2	35.92	61.8
District of Columbia	11.0	22.2	35.92	61.8
Hawaii	11.0	22.2	35.92	61.8
Montana	11.0	22.2	35.92	61.8
Delaware	9.8	21.96	35.26	60.56
Maine	10.0	22.0	35.2	60.0
Massachusetts	10.0	22.0	35.2	60.0
Oregon	10.0	22.0	35.2	60.0
Minnesota	14.0	22.8	35.08	53.8
Kansas	9.0	21.8	34.48	58.16
North Dakota	9.0	21.8	34.48	58.16
New Mexico	8.5	21.56	34.12	58.2
Ohio	8.3	21.66	34.0	56.9
Arizona	8.0	21.6	33.76	56.3
Colorado	8.0	21.6	33.76	56.3
Wisconsin	7.9	21.58	33.69	56.1
Maryland	5.0	21.5	33.6	56.3
Utah	7.75	21.56	33.58	55.7
Idaho	7.5	21.56	33.4	54.9
Arkansas	7.0	21.4	33.04	54.4
Connecticut	7.0	23.5	33.04	40.5
South Carolina	7.0	21.4	33.04	54.4
Georgia	6.0	21.2	32.32	52.5
Kentucky	6.0	21.1	32.32	52.5
Louisiana	6.0	21.2	32.32	52.5
Missouri	6.0	21.2	32.32	52.5
Oklahoma	6.0	21.2	32.32	52.5
Virginia	5.75	21.13	32.14	51.9
Nebraska	5.4	21.08	31.9	51.3
Michigan	4.6	21.0	31.32	49.1
New Jersey	3.5	20.7	30.52	47.4
Indiana	3.0	20.6	30.16	46.4
Illinois	2.5	21.25	29.8	40.2
Rhode Island	22.21% of Federal			
Vermont	26.50% of Federal			

States Which Have No Capital Gains Tax

Alabama	Mississippi	North Carolina	Tennessee
Alaska	Nevada	Pennsylvania	Texas
Florida	New Hampshire	South Dakota	Washington
			Wyoming

*This table assumes that all states will repeal existing preferences for capital gains.
Source: U.S. Chamber of Commerce

The correct solution would be for the states to either cut their income tax rates or restore the differentials. However, as recent events in New York illustrate, there are serious political hurdles in doing so. For months, New York government officials have predicted that the state would reap a $2 billion windfall from the change in the

Federal tax code unless they adjusted their tax rates downward. It is estimated that 50 percent of this windfall would come from the automatic increase in capital gains taxes. Many argue that the capital gains tax must be reduced in order to prevent capital flight. However, others believe that the entire windfall should be redistributed to the poor through tax cuts or increased welfare spending. Should the redistributionists succeed in framing the issue in terms of "rich" versus "poor," the prospects for tax rate reductions in New York and in other states will be greatly diminished.

TABLE 2

NEW YORK STATE TAX ON LONG-TERM CAPITAL GAINS FOR TOP TAX BRACKET

	1986	1988
(1) Top Federal income tax rate	50.0%	28.0%
(2) Portion not excluded for capital gains	× 0.4%	—
(3) Top Federal capital gains tax rate	20.0%	28.0%
(4) Top New York State tax rate	13.5%	13.5%
(5) Portion not excluded for capital gains	× 0.4%	—
(6) Top State capital gains tax rate	5.4%	13.5%
(7) Effect of Federal deductibility	× 50%	× 72%
(8) Effective New York State tax rate	2.7%	9.72%
(9) Effective Federal-State tax rate (8) + (3)	22.7%	37.72%

Source: U.S. Chamber of Commerce

The Economic Impact

Sharp increases in the effective tax rates on capital gains will offset some of the positive economic effects of lower marginal tax rates on salary income. First, individual investment, particularly in those investment activities that involve the most risks, would feel the sharpest impact of the change. Investment in risk capital is an important force in spurring technological innovation and enhancing productivity. However, effective capital gains tax rates approaching 40 percent – almost double the effective tax rate under prior law – will reduce risk capital investment activities by individuals.

Past experience shows the devastating impact of capital gains tax hikes on risk capital investing. In the early 1970s, the maximum tax rate on Federal capital gains was doubled from 25 percent to 49 percent. The Federal and state increase produced a top effective tax on long term capital gains of more than 55 percent. Reducing the after-tax return to risk capital investing caused risk capital to dry up. For example, the amount dedicated to organized venture capital (capital invested in new small companies with growth potential) fell from $171 million in 1969 to a low of $10 million in 1975. Overall, new capital raised through initial public stock offerings crumbled from $2.6 billion in 1969 to a bare trickle of $51 million in 1974. By contrast, after the capital gains tax reductions in 1978, there was a veritable explosion in risk capital investment with over $4.5 billion raised through venture capital companies in 1983. Likewise, new capital raised through initial public stock offering increased to $12 billion in 1983.

Second, high capital gains tax rates impede the free flow of investment capital as investors are discouraged from realizing their capital gains. This is known as the "lock-in" effect. Capital must be mobile in order to be efficient. Moreover, reduced mobility of capital does the most harm to promising growth companies. If funds are "locked-in" in existing investments, Americans are denied the creation of new technologies, new plant and equipment and new jobs.

Third, the taxation of capital gains raises the fundamental issue of tax neutrality between savings (investment) and consumption. Our tax law continues to impose multiple layers of taxation on income that is saved and invested. An individual's return from investment in commercial enterprises is taxed once at the corporate level and then again at the individual level resulting in a double tax on investment. Furthermore, the Code taxes investment income twice by taxing both the future income stream and the capitalization of that stream (the capital gain). Thus, raising the capital gains tax rate reduces the after-tax return to investment relative to consumption. Policymakers should strive to eliminate this tax bias against savings and investment.

Capital Gains and International Competitiveness

Industrial innovation, technological advancement and research and development are vital to the international competitiveness of U.S. industries. The adoption of new technology depends on investment. The capital gains differential, and its positive effect on investment in recent years, has helped the U.S. keep pace with our competitors – particularly in the high-technology race.

Under the new Code, the U.S. tax treatment of long-term individual capital gains ranks second to last among both the major industrialized countries and the high-growth Pacific Basin countries (see Table 3). In fact, some of our major international competitors like Japan, West Germany, Taiwan, Italy and South Korea, exempt long-term capital gains from federal taxation.

Chasing Illusory Tax Revenues and Income Redistribution

Sound economics and irrefutable empirical evidence make a powerful case for reducing – and even abolishing – the tax on capital gains. In fact, most of the congressional tax writers acknowledge the case against increasing the tax on capital gains. Unfortunately, the tax writers are essentially politicians, and politicians are driven more by sound politics than by sound economics. In this year's tax reform debate, sound politics meant making the distributional effects of tax reform appear more beneficial for the middle class than for the wealthy.

Under the Joint Committee on Taxation's (JCT) static

revenue model (i.e., rate reductions are assumed to have no impact on incentives, economic growth and the tax base), the dramatic reduction in the top marginal tax rate to 28 percent would have produced a more generous percentage reduction in the income tax liability for the rich than for the middle class. Raising the tax on capital gains was, in part, an attempt to offset this perceived inequity. Based on the JCT's static revenue model, increasing the capital gains tax rate increases the amount of capital gains taxes paid by upper-income taxpayers. As a consequence, after 1987, the upper-income classes ($50,000 and above) receive an average reduction in income tax liability of only 2 percent while the middle-income classes ($20,000 to $50,000) receive a 9 percent average reduction.

TABLE 3

COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN ELEVEN INDUSTRIALIZED & SIX PACIFIC BASIN COUNTRIES

Industrialized Countries

	Maximum Short-Term Capital Gains Tax Rate*	Maximum Long-Term Capital Gains Tax Rate*	Period to Qualify for Long-Term Gains Treatment
United States[1]	28%	28%	Six Months
Australia	61%	Exempt	One Year
Belgium	Exempt	Exempt	None
Canada	17%	17%	None
France[2]	16%	16%	None
Germany	56%	Exempt	Six Months
Italy	Exempt	Exempt	None
Japan	Exempt	Exempt	None
Netherlands	Exempt	Exempt	None
Sweden	50%	20%	Two Months
United Kingdom[3]	30%	30%	None

Pacific Basin Countries

	Maximum Short-Term Capital Gains Tax Rate*	Maximum Long-Term Capital Gains Tax Rate*	Period to Qualify for Long-Term Gains Treatment
United States[1]	28%	28%	None
Hong Kong	Exempt	Exempt	None
Indonesia	35%	35%	None
Malaysia	Exempt	Exempt	None
Singapore	Exempt	Exempt	None
South Korea	Exempt	Exempt	None
Taiwan	Exempt	Exempt	None

[1]1988 capital gains tax rate
[2]Gains from proceeds of up to $27,237 (FF 251,500) are exempt from taxation in a given taxable year.
[3]The first $7,140 (£5,600) of gain is exempt annually.
*State, provincial and local tax rates not included.

Source: Arthur Anderson & Co., June 1985

However, raising the tax on capital gains will, over the long-run, produce the exact opposite of what the tax writers intended. This is because higher capital gains tax rates reduce taxpayers' willingness to realize capital gains, thus reducing the amount of tax revenue the Federal government actually receives. Cutting the tax would produce more federal tax revenue and increase the proportion of total taxes borne by the wealthy. The evidence from the 1978 capital gains rate reduction proves this point. The reduction in the maximum capital gains tax rate from 49 percent to 28 percent led to an increase in capital gains taxes paid by all income classes (see Table 4). More importantly, net long-term capital gains paid by the wealthy with adjusted gross incomes of over $500,000 were $1.8 billion in 1978 and $4.2 billion in 1981. This constitutes a 130 percent increase in taxes paid even though the tax rate fell by 43 percent.

TABLE 4

NET LONG-TERM CAPITAL GAINS (1978-1981)

Net Income Class (Thousand)	Net Long-term Gains ($Billions) 1978	1981	Percent Change 1978-1981
0-25	$9.7	$13.2	36.1%
25-50	9.0	10.2	13.3
50-100	6.6	11.2	69.7
100-500	8.6	19.0	120.9
500-above	3.7	14.9	302.7

Source: Internal Revenue Service

A recent econometric study by Lawrence B. Lindsey analyzing the data on capital gains tax rates, realizations and household wealth found that "a one percentage point reduction in the capital gains tax rate resulted in 6.2 percent more net gains realized. The implication of this finding is that revenues from capital gains taxes are maximized when the capital gains tax rate is 16 percent. At higher tax rates, the revenue gained from taxing realized gains at higher rates is more than offset by a reduction in the amount of capital gains realized."

Fixing Capital Gains

Capital gains can be fixed by restoring the differential and reducing the tax rate or, at the very least, indexing capital gains. There are two basic considerations in determining the level of the capital gains tax rate. One is the revenue effect of a given tax rate and the other is the economic efficiency effect of a given tax rate. They are not necessarily the same tax rate. Empirical evidence suggests that both rates are lower than the previous 20 percent tax rate. As mentioned earlier, Lindsey found that 16 percent is the revenue maximizing capital gains tax rate. In contrast, a zero tax rate may be optimal from an economic efficiency standpoint. Given today's Federal deficit constraints, 16 percent may be the lowest rate that can be achieved at this time. Under the tax reform law's lower marginal tax rates, a 43 percent exclusion from ordinary income is required to cut the top Federal capital gains tax rate from 28 to 16 percent. Likewise, the corporate capital gains tax should be reduced to the previous alternative rate of 28 percent—or lower depending on econometric estimates of the revenue maximizing tax rate.

At a very minimum, capital gains should be indexed to the extent that such gains are inflationary. During the 1970s, high inflation led people to pay taxes on nominal capital gains and sometimes real losses (i.e., taxable gains when adjusted for inflation were often actual losses). Some argue that tax cost-basis indexing does nothing to encourage risk-investment. Nonetheless, indexing is necessary because taxing inflationary gains is inherently unfair.

Conclusion

In conclusion, tax reform's reduction in marginal tax rates is a major victory. Lower tax rates reduce the tax bias against work, savings and investment. However, constrained by the fantasy world of static revenue neutrality, the tax writers made tax changes that will tend to offset some of the positive economic effects of lower rates. Let's not deny Americans the full benefit of tax reform. The restoration of the Federal capital gains differentials for individuals and corporations will reduce the tax bias against savings and investment, solve the problem of the "one-two" punch from Federal and state capital gains taxation (since most states would automatically restore the state exclusion), boost U.S. international competitiveness and promote a fairer distribution between the middle class and the wealthy. Capital gains is the one area that the President and the Congress should strive to correct next year.

A MEDICARE CATASTROPHE IN THE MAKING

by
William Orzechowski

President Reagan's philosophy of reducing government intervention in the private sector is being undermined. In November of this year, the Department of Health and Human Services (HHS) released a report which recommended expanding the government's role through a new federal catastrophic insurance plan. The adoption of this recommendation would take insurance coverage now provided in the private sector and shift it to the public sector. In so doing, the Administration is stepping backwards from its commitment to privatization.

The substance of the HHS recommendation stands in contrast to President Reagan's 1986 State of the Union address. President Reagan asked HHS to conduct an Administration study of "how the private sector and government can work together to address the problems of catastrophic health care." In response to this presidential directive, HHS is expected to offer a solution which transforms a highly competitive market composed of over 200 private firms into a government monopoly.

The issue arises because, under the current Medicare system, a patient's bill can accelerate sharply after 60 days of hospital care. While all hospital stays are subject to a deductible of $524, the patient must pay co-insurance fees of $123 a day for the 61st to 90th days of a hospital stay and $246 each day for the use of "lifetime reserve days" – an additional 60 days of coverage which may be used once during the individual's lifetime. Fewer than one percent of the elderly ever exceed hospital stays of 60 days. However, after Medicare coverage is exhausted, the patient is on his own. Nevertheless, private insurance is widely available to supplement Medicare coverage.

In fact, about 70 percent of the elderly are covered by supplemental health insurance or "Medigap" policies. About half of the remaining elderly have coverage provided through Medicaid, and private coverage is available to the rest.

In most states, catastrophic health insurance policies are required to provide a minimum of 365 days of hospital care (a rare event) beyond the Medicare limits, and the policies cover the Medicare deductible and co-insurance fees as well. Insurance coverage is also available to the elderly through subscriptions to health maintenance organizations (HMOs) which provide medical services in return for a fixed monthly fee. Private insurers are also beginning to experiment with long-term nursing care policies which Medicare does not provide.

In the face of this thriving competitive insurance industry, HHS is expected to recommend a new federal program. Coverage would be offered through Medicare to those elderly who agree to pay an additional premium of $60 per year. This coverage would limit the beneficiary's out-of-pocket expenses for all covered services to $2,000 per year. The coverage is to be unsubsidized, with the $60 premium intended to cover all costs.

HHS expects the federal catastrophic program to eventually take over the private Medigap market. In effect, they are working on the assumption that a government monopoly will charge a lower price than a private, competitive industry. To our knowledge, without large taxpayer subsidies, there are few or virtually no instances of this phenomenon. In a forthcoming study by the National Chamber Foundation, a separate research affiliate of the U.S. Chamber of Commerce, shows that it is highly unlikely that catastrophic medical care can be provided without subsidies.

The Foundation's study demonstrates that the costs of the federal program have been seriously underestimated. Apparent savings are due to: (1) the failure to account for all costs, (2) inadequate comparisons with private insurance plans and, (3) a failure to take account of bureaucracy and political dynamics.

According to its sponsors, the primary advantage of the

federal plan is economies of scale. It is alleged that the federal plan will lower per unit costs as it takes business away from the private market. The ultimate objective is for the federal government to enroll at least 75 percent of the eligible beneficiaries. According to the HHS actuaries, this is the minimum amount necessary to make the program sound. This would, of course, virtually destroy the private Medigap sector which is about the same size.

In fact, **the economies of scale argument is a hoax.** It is true that costs per unit fall as the size of an enterprise grows. However, there is a point at which maximum efficiency is reached and from there diseconomies of scale emerge. In the Medigap market this optimum organizational size has been shown to be considerably below the behemoth federal model. There are over 200 companies now writing Medigap policies. If economies of scale were such a major factor, the industry would be dominated by a few firms or a private monopoly, but clearly it is not.

HHS cost comparisons are flawed. HHS claims that its $60 annual premium underprices current private plans. However, the private plans used in the comparison offer more coverage. For example, private policies cover Medicare's $492 first day deductible which is frequently incurred. The private policies also cover the initial supplementary medical insurance (SMI) co-insurance fees and often the SMI deductible. The federal catastrophic plan does not include coverage for such items. In fact, there are private companies that offer policies with virtually the same coverage as the federal plan for less than $60 a year in premiums.

HHS underestimates the costs of the federal program. For example, without substantial subsidy, the federal insurance plan will have to be aggressively marketed. Since the federal plan's premium is expected to be unsubsidized, such costs will be large. Only if the federal government makes it mandatory to join the program can such costs be eliminated. However, the consumer would lose his freedom of choice, and it stretches the imagination to believe that a government monopoly with mandatory participation could do a better job than a competitive market.

Most important of all, HHS fails to take account of bureaucracy and political dynamics. Physicians, hospitals and patients under the federally-guaranteed plan would be inclined to opt for more expensive and prolonged care even though it may not be required. The managerial and administrative inefficiency associated with public bureaucracy would have to be covered as well. Have we forgotten the Grace Commission? Our elected representatives would be under enormous strain to expand benefits without increasing premiums. Costs would soar beyond original estimates, and the next generation would be stuck with liabilities in the trillions as is the case with the existing Medicare plan.

For example, the Medicare program itself was originally estimated to cost $4 billion by 1980; it actually cost $32 billion that year – an eight-fold increase. To keep this program solvent for the next generation means that the Medicare payroll tax will have to nearly triple, making it equal to about half of today's combined Social Security and Medicare payroll tax. This translates into a combined employer-employee payroll tax of nearly 25 percent. The political dynamics of federal catastrophic insurance will only add to the climbing payroll tax burden which is already a bulwark against economic growth.

Given a rich history of bureaucratic failure, it is inconceivable that the federal government can do the job better than the private sector. Bureaucratic inefficiency and political pressures for program expansion would lead to spiraling costs that would be passed onto the general taxpayer. The result would be a time bomb set for a massive cost explosion.

The truth is that the private sector is presently doing a good job. For example, private HMOs in return for taking the responsibility of providing Medicare, receive a government payment that covers 95 percent of the average cost per beneficiary under Medicare. To attract elderly customers under this program, most HMOs offer catastrophic coverage at no extra charge. In other words, HMOs are providing the health care obtainable under Medicare coverage, plus catastrophic coverage, for only 95 percent of what it costs the government to provide Medicare alone.

Finally, the public should not be fooled by the misleading claims of the federal program's sponsors. Health and Human Services has stated that for "five dollars a month" we can give the elderly "real peace of mind." The impression being given is that the new catastrophic federal program will cover all medical needs of the elderly. The truth, of course, is that the plan has a smaller range of coverage than present private programs.

On a more serious note, they are leading the public to believe that heavy financial burdens such as long-term nursing care will be covered by the new federal program. This is simply not true. However, through the development of Health Care IRA's or alternative tax credit mechanisms, enterprises and individuals could be encouraged to develop a private insurance system for long-term nursing care. Instead of focusing upon ways to develop such private alternatives, HHS is giving the erroneous impression that its new catastrophic plan is going to do the job.

Given the existence of a vigorous and competitive private catastrophic medical insurance system, there is no need for a new federal program which would mock the whole notion of privatization. Secretary Bowen should be

encouraged to drop such a plan and instead, recommend, in line with President Reagan's request, further ways to stimulate the development of private medical insurance systems. Doing so will enable us to avoid the grave financial difficulties associated with current entitlement programs, furthering President Reagan's goals of reducing government spending and interference in the private sector and expanding the role of the free market.

TRENDS IN COMMERCE
NOTES ON TABLE II
DECEMBER 1986/JANUARY 1987

by
*Martin Lefkowitz**

Gross National Product (GNP) – The revised estimate of Gross National Product – the total value of goods and services produced in the economy – shows that third quarter GNP grew at a 2.8 percent annual rate. Final sales, after adjusting for inflation, rose at a robust 4.5 percent annual rate, with one-half of the increase attributed to auto sales. However, most of the increase in auto sales came from dealer inventories rather than current production. Consumer spending remained strong, growing at a 6.7 percent rate in the third quarter. Increases were also evident in residential investment and government spending. The third quarter data continued to reflect a widening of the trade deficit, with exports rising by 13.3 percent while imports increased at a much faster rate of 17.3 percent.

The Services Sector – Employment in service sector establishments increased by 266,000 jobs in October and is now 2.4 million jobs above its year-ago level. This compares with a decline of 21,000 jobs in the goods-producing sector over the last twelve months. Over the past year, the manufacturing sector has lost 110,000 workers. All of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services increased by 0.3 percent in October. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 22.3 billion in October, an increase of 17 percent from its year-ago level. Over the past ten months, domestic passenger travel has increased 12.6 percent and available seat miles were up 12.7 percent. International passenger traffic declined 2.4 percent in October compared to October of last year.

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Money Supply – The nation's money supply – as measured by M1, currency in circulation plus demand deposits – increased by 1.2 percent in October and was 14.2 percent above its year-ago level. In the six months ended in October, M1 was up at an annual rate of 17.1 percent. This is considerably above the Fed's target range of three to eight percent.

Employment – The civilian unemployment rate remained at 7.0 percent in November for the third consecutive month. Employment hit a new record in November, with 110.4 million persons at work, an increase of 2.4 million persons since November of 1985. Nonagricultural payroll employment – as measured by the monthly survey of establishments – rose by 250,000 to 101.1 million. The largest over-the-month increase in the service-producing sector took place in the services industry, with both business and health services contributing to the increase. In November, the civilian labor force increased to 118.7 million. In the first four years of this recovery, nonfarm payroll employment has grown by 12 million, and total civilian employment has increased by 11 million.

Consumer Price Index – The Consumer Price Index for all urban consumers (CPI-U) rose by 0.2 percent in October, following a 0.3 percent increase in September. This decline was mainly attributable to the 2.2 percent falloff in energy prices. Over the past ten months the index rose at a seasonally adjusted annual rate of 0.7 percent. Consumer prices were held down by energy prices which were falling at a 22.7 percent annual rate. Excluding the decline in the prices of energy products, prices increased at a 3.8 percent annual rate over the past ten months, about the same rate as in 1985.

The Producer Price Index for finished goods increased by 0.2 percent in November after rising 0.3 percent in October. The November increase was held down because of lower energy prices which offset large increases in food and auto prices. Over the past year, finished goods prices at the wholesale level have declined 1.9 percent. The intermediate goods index rose by 0.2 percent, the result of a rise in energy prices, which rose by 0.3 percent from October to November. However, the crude goods index remained unchanged in November, after jumping 1.6 percent in October. Crude food prices fell 0.2 percent in November following a 2.6 percent rise in October.

Housing Starts – Privately owned housing units were started at a seasonally adjusted annual rate of 1,648,000 units in October, virtually unchanged from the September level. October housing starts were nearly 8 percent below the October 1985 level. The data reflected a continued decline in apartment construction, (down over 35 percent since last April), which many attribute to tax reform legislation, while single-family home construction increased by one percent. In October, new home starts de-

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Oct/86	242.2	242.0	239.3	0.0	1.2
Gross National Product ($B)	III/86	4,240.7	4,175.6	4,030.5	1.6	5.2
Gross National Product (82$B)	III/86	3,686.4	3,661.4	3,603.8	0.7	2.3
Money Supply (M1) ($B)	Oct/86	701.2	693.1	614.2	1.2	14.2
Money Supply (M2) ($B)	Oct/86	2,764.4	2,740.2	2,538.9	0.9	8.9
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Oct/86	2,773.0	2,830.1	2,644.0	−2.0	4.9
Personal Consumption Expenditures (82$B)	Sep/86	2,466.7	2,445.2	2,366.5	0.9	4.2
Disposable Personal Income ($B)	Oct/86	2,995.4	2,988.0	2,860.9	0.2	4.7
Disposable Personal Income (82$)	Sep/86	2,604.3	2,611.0	2,523.1	−0.3	3.2
Personal Savings Rate (%)	Oct/86	4.1	2.0	4.5	2.1[b]	−0.4[b]
Civilian Employment (millions)	Nov/86	110.4	110.2	108.0	0.2[c]	2.2[c]
Civilian Unemployment Rate (%)	Nov/86	7.0	7.0	7.0	0.0[b]	−0.0[b]
Average Hourly Earnings	Nov/86	$8.84	$8.80	$8.65	0.2	2.2
Consumer Price Index (All Urban, 67 = 100) [a]	Oct/86	330.5	330.2	325.5	0.2	1.5
Prime Interest Rate (%) December 3, 1986		7.5	8.5	9.5	−0.5[b]	2.0[b]
Retail Sales ($B)	Nov/86	122.3	121.6	115.4	0.5	5.9
SERVICES SECTOR						
Employment in Services (Millions)	Oct/86	75.9	75.6	73.5	0.4	3.3
Consumer Purchases of Service ($B)	Oct/86	1,464.2	1,459.1	1,367.1	0.3	7.1
Consumer Purchases of Service (82$B)	Sep/86	1,184.1	1,183.1	1,142.4	0.1	3.7
Domestic Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Oct/86	22.3	21.1	19.0	5.7	17.4
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	III/86	241.3	231.3	229.2	4.3	5.3
Profits Tax Liability	III/86	97.4	93.3	95.8	4.4	1.7
Tax Liability as a Percent of Profits	III/86	40.4	40.3	41.8	0.1[b]	−1.4[b]
After Tax	III/86	143.9	138.0	133.4	4.3	7.9
Net Cash Flow	III/86	387.0	380.6	382.8	1.7	1.1
Industrial Production (77 = 100)	Oct/86	125.2	125.2	123.6	0.0	1.3
Capacity Utilization Rate (Mfg.) (%)	Oct/86	79.0	79.6	79.4	−0.6[b]	−7.6[b]
New Housing Starts (thou. units)	Oct/86	1,648.0	1,652.0	1,784.0	−0.2	−7.6
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	III/86	169.1	168.0	164.4	0.6	2.8
Unit Nonlabor Costs (nonfarm) (77 = 100)	III/86	163.4	161.9	161.4	0.9	1.2
Producer Price Indices (67 = 100) [d]						
Crude Materials	Nov/86	278.4	276.7	304.7	0.6	−8.6
Intermediate Goods	Nov/86	304.9	304.9	318.1	0.0	−4.1
Finished Goods	Nov/86	290.7	290.5	296.4	0.1	−1.9
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Oct/86	591.1	590.8	596.9	0.1	−1.0
Federal Gov't Gross Debt Outstanding ($B) [a]	Oct/86	2,035.6	2,012.6	1,758.3	1.1	15.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	III/86	368.0	363.0	362.3	1.4	1.6
Imports of Goods & Services ($B)	III/86	476.1	467.5	446.0	1.8	6.7
Balance on Goods & Services ($B)	III/86	−108.2	−104.5	−83.7	3.5	29.6
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Oct/86	180.5	179.5	171.6	0.6	5.2

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] January data is a new series that is not comparable to previous data
[d] Index number not seasonally adjusted, percent change seasonally adjusted

clined in the Northeast and the Midwest, but were up in the South and West. Building permits, an indicator of future activity in the home building industry, were down 3 percent for the month, representing the fourth consecutive monthly decline in permits.

Corporate Profits and Cash Flow – Corporate profits have been sluggish for the past year. Pre-tax profits increased by 4.3 percent between the second quarter and third quarters of 1986. Economic profits, which take into account economic depreciation and adjust for changes in inventory valuation, were up 2.2 percent from their year-ago level. Net corporate cash flow, which includes depreciation allowances, was one percent below the fourth quarter of 1985.

Industrial Production – Industrial production rose 0.6 percent in November, following a 0.1 percent increase in October. Production in November was 0.8 percent higher than its year-ago level. The increases in output occurred in defense, durable and nondurable consumer goods. Industrial production showed no change in the auto and truck industries.

The October capacity utilization rate declined 0.2 percentage points to 79 percent, 2.5 percentage points below its peak level for the current expansion in the summer of 1984. Over the past year, durable goods capacity expanded by 2.4 percent, and nondurable goods capacity increased by 2.8 percent. Mining capacity declined as a result of a falloff in drilling activity and is now at less than half of its 1985 level.

Productivity – Nonfarm business productivity increased at a seasonally adjusted annual rate of 0.2 percent in the third quarter of 1986, compared to a 1.6 percent increase in the previous quarter. Third quarter output rose by 3.2 percent while hours worked declined by 3.0 percent. Manufacturing productivity rose at a 4.2 percent annual rate for the quarter, and output increased at a 4.2 percent annual rate, while hours worked rose by 0.8 percent. This small increase in hours worked coupled with a relatively large increase in output, resulted in a 1.5 percent drop in unit labor costs in the manufacturing sector.

Interest Rates – The prime interest rate is currently 7.5 percent, 2.0 percentage points below its year-ago level. Three-and six-month Treasury bill rates which were 5.2 and 5.4 percent, respectively, in early October also ended the month at very close to that level. Thirty-year Treasury bonds traded at 7.6 percent at the end of October, the same as in late September.

Federal Spending – The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased to 591.1 in October (1967 = 100), a 0.1 percent increase from the previous month and one percent below the level of October 1985. Federal receipts for October, the first month of fiscal year 1987, increased by 1.9 percent, while expenditures for the same period were actually one percent below the year-ago level. The federal deficit in October was $25.2 billion, $1.9 billion less than the same period last year.

Personal Savings – The personal savings rate was 4.1 percent of after-tax income in October, twice the rate reported in September when consumer spending increased significantly. The October savings rate was the highest in four months.

Retail Sales – Retail sales increased 0.5 percent in November after a 5.2 percent decline in October and a 5.3 percent increase in September. Sales rose 5.9 percent above their level of November 1985. For the past few months, retail sales have been heavily influenced by auto dealer promotions and discounts. Hardware stores, auto dealers, and furniture stores reported double-digit increases in sales this November compared to sales in November of 1985.

Trade Deficit – The U.S. merchandise trade deficit improved greatly in October shrinking to $12.1 billion, the smallest trade deficit since August 1985. The increase in exports was the highest since March 1985. Agricultural exports have picked up, but a large part of the decline in the merchandise trade deficit was due to a significant decrease in imports of manufactured goods. On a goods and services basis, the trade deficit in the third quarter of 1986 was $110.1 billion.

What's Ahead – The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased by 0.6 percent in October. Five of the 11 indicators available for October were up, and six were down. This indicator has moved up in three of the last four months. The positive contributors to the October increase were money supply, changes in sensitive material prices, an increase in credit outstanding and fewer persons filing for unemployment compensation.

STUDY FORECASTS RAPID GROWTH IN HOUSING INDUSTRY

According to a new study to be released soon by Salomon Brothers Inc., the U.S. housing industry is expected to grow through the end of the decade at levels that exceed current projections. The study, which is the first to dispute widespread projections that housing needs would average about 1.6 million to 1.7 million units per year through the end of the decade, projects that annual housing demand will be 1.9 million units through 1990. According to Salomon's projections, the increase in hous-

ing demand would be felt in other areas of the home building industry such as roofing, lumber, and cement and could, as a result of the increased demand, contribute to GNP growth far more than their current average contribution of 4.5 to 5.0 percent.

PROJECTED CHANGES IN EMPLOYMENT[1] 1984–1995

Most New Jobs	Gain in Thousands
Business services	2,633
Retail trade, except eating and drinking places	1,691
Eating and drinking places	1,203
Wholesale trade	1,088
Medical services[2]	1,065
Professional services[2]	1,040
New construction	558
Doctors' and dentists' services	540
Hotels and lodging places	385
Credit agencies and financial brokers	382
Fastest Growing	**Average Annual Percent Change**
Medical services[2]	4.3
Business services	4.2
Computers and peripheral equipment	3.7
Materials handling equipment	3.7
Transportation services	3.5
Professional services[2]	3.5
Scientific and controlling instruments	2.9
Medical instruments and supplies	2.8
Doctors' and dentists' services	2.6
Plastics products	2.5
Most Rapidly Declining	**Average Annual Percent Change**
Cotton	−4.2
Wooden containers	−3.6
Leather products, including footwear	−2.8
Iron and ferroalloy ores mining	−2.7
Sugar	−2.7
Leather tanning and finishing	−2.6
Railroad transportation	−2.6
Nonferrous metal ores mining, except copper	−2.6
Dairy products	−2.3
Blast furnaces and basic steel products	−2.2

[1]Includes wage and salary jobs, the self-employed and unpaid family workers.
[2]Not elsewhere classified.

Source: Bureau of Labor Statistics

U.S. STANDARD OF LIVING RISES

A joint report recently released by the U.S. Department of Commerce and The Conference Board reveals that Americans have improved their standard of living by about 20 percent over each decade since 1940. The report also stated that the amount of goods and services consumed by the average American has doubled since 1950–spurred by worker productivity which has also doubled since that time. In addition, the report found that the number of Americans who earn a paycheck has risen by 50 percent over the last two decades; real net worth of U.S. households has tripled since 1950, and average family income has risen to about $33,000 from $17,125.

INDUSTRY TRADE DEFICITS 1985

	1985 ($ Billions)	1980–1985 (Percent Change)
Motor vehicles	$39.8	+216%
Apparel, accessories	15.3	+173
Telecommunications, sound equipment	14.4	+336
Miscellaneous consumer goods	10.3	+506
Iron, steel	9.9	+98

Source: Fortune, December 8, 1986

INDUSTRY TRADE SURPLUSES 1985

	1985 ($ Billions)	1980–1985 (Percent Change)
Aircraft, transportation equipment	$11.2	−3%
Office machines, computers	3.8	−55
Professional, scientific instruments	3.4	−15
Specialized industrial machinery	2.2	−255
Synthetic resins, plastics	2.1	−52

Source: Fortune, December 8, 1986.

THE BIG GAINERS AMONG U.S. EXPORTERS

($ Millions)

	April-August 1985	April-August 1986	Percent Change
Paperboard	$713	$845	18.5%
Medical & Pharmaceutical Products	1,133	1,299	14.7
Metalworking Machinery	536	610	13.8
Electrical Parts & Appliances	5,049	5,744	13.8

Source: Businessweek, November 3, 1986.

HOURLY WAGES FOR SELECTED INDUSTRIES

(Production and Nonsupervisory Workers)

Basic steel	$14.08
Railroads	13.02
Motor vehicles, equipment	13.40
Telephone communications	12.80
All construction	12.31
Trucking and terminals	10.79
Machinery	10.57
Stone, clay, glass	10.06
Bakery products	9.91
All manufacturing	9.74
Electrical, electronic equipment	9.68
Hospitals	9.41
All services	8.04
Auto repair	7.51
Banking	7.15
Textile mill products	6.90
Department stores	6.61
Hotels, other lodging	5.81
Apparel, other textiles	5.76
Footwear, except rubber	5.59

Source: U.S. Department of Labor

VALUE OF OUTPUT FOR SELECTED INDUSTRIES

	Percent Change 1982-85	4th Q 85/4th Q 86
Motor vehicles	19.15%	-2.73%
Building materials	19.03	-1.53
Appliances	9.26	1.69
Steel mills	-4.24	-6.92
Aircraft	9.93	3.95
Radio-TV	10.53	7.75
Pulp, paperboard	4.46	6.57
Paperboard boxes	0.56	8.71
Farm machinery	-5.86	-6.20
Newspapers, books	2.00	7.37
Apparel	-0.44	4.25
House furniture	12.52	-2.53
Drugs, soaps	-1.66	9.20
Beverages	-0.19	8.92
Scientific instruments	5.07	3.73

Source: U.S. Department of Commerce

COMMERCE DEPARTMENT REPORTS GROWTH IN STATE PER CAPITA INCOME FOR 1985

According to revised estimates by the U.S. Department of Commerce, average per capita personal income for the United States rose to $13,867 in 1985 as compared to $13,114 in 1984. During 1985, state per capita income ranged from $18,187 in Alaska and $18,089 in Connecticut to $9,187 in Mississippi.

Eight states had per capita incomes 7 percent above the U.S. average, with most of these states concentrated in the New England and Mideast regions of the country. Those states which had low per capita incomes were primarily located in the Southeast, Southwest, and Rocky Mountain regions.

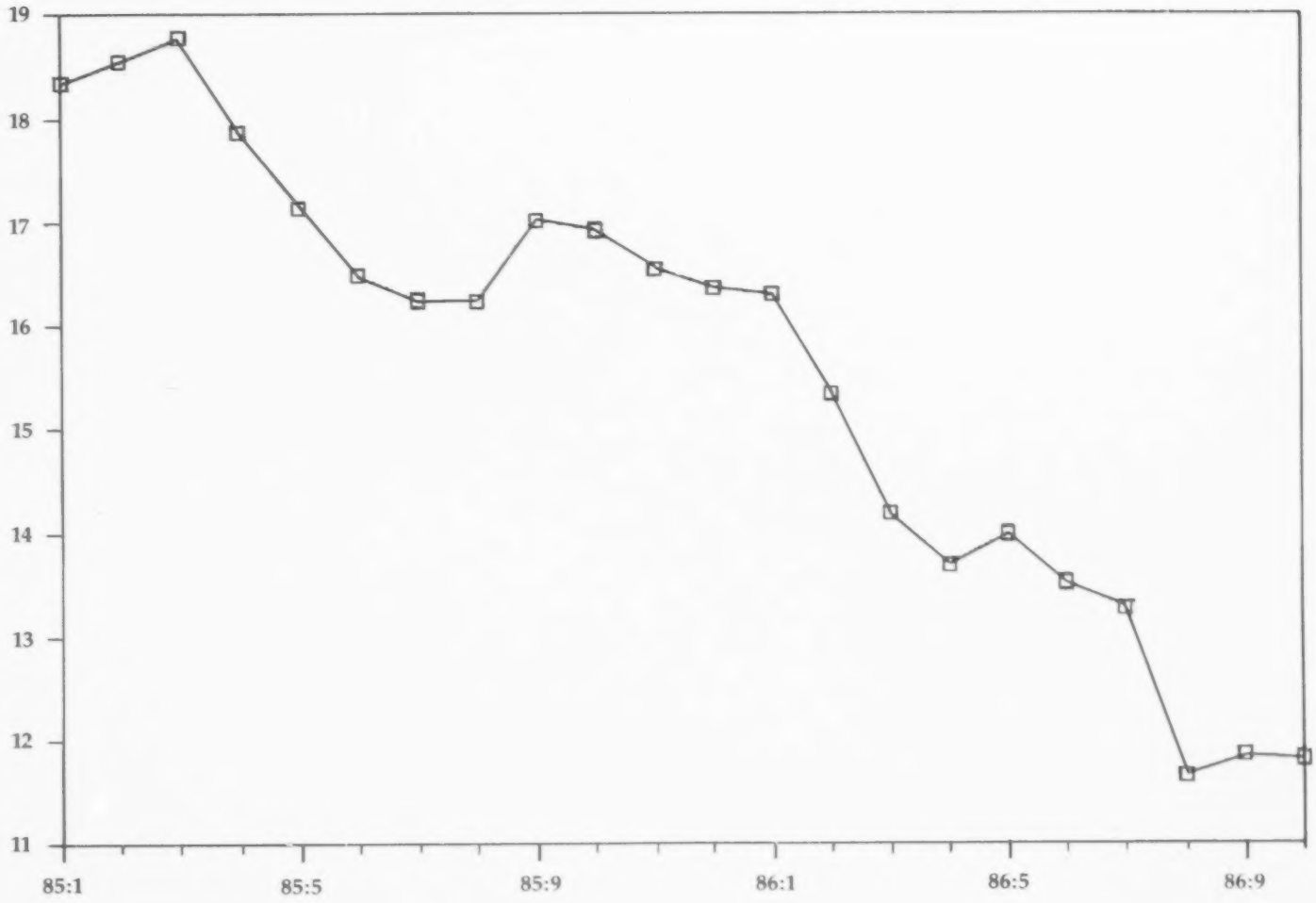
During the 1982–1985 period, per capita personal income increased 20.9 percent nationally. Those states showing the largest percentage gain in per capita personal income during this period included: New Hampshire (+30.6%), Massachusetts (+28.5%), Connecticut (+26.9%), Georgia (+26.7%), New York (+25.5%), New Jersey (+25.3%), North Carolina (+25.1%), Maryland (+24.9%), Virginia (+24.7%), and Maine (+24.2%).

Among those states which had the smallest percentage increase in per capita personal income were: Alaska (+5.1%), Wyoming (+7.0%), Oklahoma (+7.4%), Louisiana (+8.9%), Montana (+8.9%), West Virginia (+12.1%), North Dakota (+14.3%), Washington (+15.2%), New Mexico (15.2%), and Texas (+15.3%).

CENSUS BUREAU REPORT SHOWS POVERTY RATE FELL IN 1985

The Census Bureau, in its annual report on poverty and income, reported that 14 percent of the American population had incomes below the official poverty line during 1985, a decline from 1984. During 1985, median family income rose to $27,735, a 1.3 percent inflation-adjusted gain. The poverty rate among whites fell from 11.5 percent in 1984 to 11.4 percent in 1985; among blacks, it fell from 33.8 percent to 31.3 percent.

Consumer Installment Credit Outstanding
(percent change from year ago)



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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

February/March 1987

POLICY RISKS THREATEN ECONOMY

As the economy enters its fifth year of recovery, all signs point to a continuation of moderate rates of economic growth. We anticipate an increase in real GNP of 3% this year and 3.6% in 1988. The latest data releases show that 1986 ended on a relatively strong note. Increases in personal income, together with the tax reform related rush to purchase big ticket items, contributed to a 2% rise in consumer spending in December. As a result, industrial production increased by 0.5% and the capacity utilization rate rose to nearly 80%. Housing starts also improved significantly, rising by 14% in December and remaining at 1.8 million units in January. This burst of activity led to a decline in the civilian unemployment rate to 6.7% in both December and January. Encouragingly, manufacturing employment also increased for the fourth consecutive month. This performance was accompanied by no noticeable acceleration in inflation as the consumer price index increased by only 0.1% in December.

More importantly, the index of leading indicators posted an impressive 2.1% surge. Some of the indicators which contributed to the increase were building permits, new orders for consumer goods and materials, and contracts and orders for plant and equipment. This improvement presages increased activity this spring and summer.

The sources of economic growth during the next two years are likely to be quite different from what we have experienced so far. The investment sector is expected to make the smallest contribution to GNP growth because it is constrained by the effects of tax reform. Residential investment is expected to rise by 2.8% in 1987 and 2.3% in 1988. Nonresidential investment should increase by only 2.9% this year and 5.9% in 1988.

Consumer spending, which buoyed economic activity in 1985 and 1986 should continue to support economic growth, although it will not be the leading influence it was in the past. Large increases in consumer spending during the last two years have satisfied a significant portion of pent-up demand for durable goods. Moreover, relatively high levels of consumer indebtedness plus the phase-out of the non-mortgage interest expense tax deduction may begin to act as a constraint on both borrowing and discretionary spending. We expect that real consumer spending will rise by 2.5% in 1987 and 2.9% in 1988.

This leaves inventory investment and net exports as the major contributing factors to economic growth this year and next. After falling during the second half of last year, real inventory accumulation is expected to resume, reaching $18.2 billion this year and $29.2 billion in 1988. We anticipate a turnaround in real net exports. The evidence shows that the impact of currency changes does not show up in the trade figures until approximately two years later. For instance, while the dollar began to appreciate in late 1979, net exports did not decline significantly until mid-1982 and did not turn negative until mid-1983. Thus, the dollar's depreciation should soon begin to have a positive effect on real GNP. In fact, this turnaround was evident during the fourth quarter, when exports rose by 13.6% and imports fell by 0.2% (a significant improvement following the third quarter's 17.3% growth rate). As a result, real net exports (exports minus imports – the relevant variable in terms of GNP) rose by $12.3 billion. While one quarter does not make a trend, it should be noted that, with the exception of the months of July and November 1986, the merchandise trade deficit has been on a declining path since May.

Despite our relative optimism, we are concerned about a number of policy risks facing our economy. Chief among our concerns are that: (1) a major tax increase will be enacted; (2) the resurgence in export growth will not be as strong as expected; (3) short-sighted protectionist legislation will be enacted; and (4) excessive growth in the money supply will trigger higher inflation.

The Tax Increase Threat

During the past twenty-two years, government rev-

Dr. Richard W. Rahn, Vice President and Chief Economist.
Ms. Graciela Testa-Ortiz, Director, Forecast Section.

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986–1988
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual		Forecast							Actual		Forecast	
	86:3	86:4	87:1	87:2	87:3	87:4	88:1	88:2	88:3	1985	1986	1987	1988
GROSS NATIONAL PRODUCT													
Real GNP	2.8	1.3	3.3	3.7	4.3	4.5	3.8	3.1	2.6	2.7	2.5	3.0	3.6
Consumption	6.7	-0.1	1.1	2.9	4.0	1.6	3.2	3.0	3.0	3.5	4.1	2.5	2.9
Residential Investment	9.7	6.2	-1.8	-1.6	2.9	6.5	2.2	1.4	0.1	3.9	9.5	2.8	2.3
Nonresidential Investment	-2.1	1.0	3.2	9.1	6.7	8.0	5.5	4.3	4.8	9.3	-1.1	2.9	5.9
Equipment	1.2	4.9	3.9	9.7	8.1	9.3	4.9	3.8	4.5	10.1	4.1	5.1	6.1
Structures	-9.8	-7.2	1.4	7.7	3.1	4.7	7.3	5.5	5.8	7.7	-11.7	-2.4	5.5
Exports	13.3	13.6	10.9	11.6	11.4	8.5	13.3	6.2	6.1	-2.0	2.3	10.8	9.3
Real Net Exports (82$B)	-163.3	-151.0	-148.2	-144.0	-142.9	-141.0	-134.2	-131.7	-127.7	-108.2	-148.6	-144.0	-130.3
Imports	17.3	-0.2	2.1	5.1	7.5	4.9	4.8	3.0	1.8	3.8	10.4	6.6	4.4
Government Purchases	2.5	25.9	-15.6	-4.1	6.9	15.8	-14.1	-0.1	4.4	10.9	2.8	2.6	0.6
Final Sales	8.3	4.0	4.6	7.0	7.8	8.1	6.9	7.4	7.8	4.2	2.6	5.9	7.5
Change in Business Inventories (82$B)	0.3	-24.1	15.0	19.6	17.6	20.7	33.7	35.0	26.3	9.0	7.6	18.2	29.2
Industrial Production	1.9	3.2	4.7	5.9	6.1	6.5	4.5	3.4	2.4	2.6	0.5	4.1	4.6
New Car Sales (mill.)	13.2	11.5	10.8	11.5	11.9	11.6	11.6	11.6	11.7	11.2	11.6	11.5	11.6
Domestic Car Sales (mill.)	9.7	7.9	7.3	8.0	8.6	8.4	8.5	8.6	8.7	8.2	8.4	8.6	
New Housing Starts (mill.)	1.91	1.75	1.65	1.63	1.63	1.68	1.69	1.66	1.69	1.74	18.2	1.66	1.69
EMPLOYMENT, WAGES & PRICES													
Civilian Unemployment Rate (%)	6.9	6.8	6.8	6.7	6.5	6.2	6.0	5.8	5.6	7.2	7.0	6.5	5.7
Compensation	2.5	3.1	3.7	3.9	4.1	4.4	5.0	5.0	5.2	4.0	3.0	3.5	4.8
Productivity	0.4	0.0	1.8	2.0	1.7	1.7	1.2	0.9	0.8	0.5	0.9	1.2	1.3
Unit Labor Costs	2.2	2.7	2.1	1.9	2.4	2.7	3.8	4.1	4.3	3.7	2.1	2.3	3.4
Consumer Price Index	2.6	2.5	4.3	4.2	4.4	5.1	4.8	4.9	4.7	3.5	1.9	3.4	4.8
Implicit GNP Deflator	3.6	0.7	3.5	3.6	3.2	3.8	4.2	4.2	4.2	3.3	2.6	2.9	4.0
Prime Interest Rate (%)	7.9	7.5	7.4	7.1	6.9	7.0	7.4	7.5	7.8	9.9	8.3	7.1	7.7
3-mos. Treasury Bill Rate (%)	5.5	5.3	5.2	4.9	4.8	4.9	5.0	5.2	5.4	7.5	6.0	4.9	5.3
Corporate Bond Rate (%)	8.8	8.7	8.4	8.2	8.0	7.9	8.0	8.0	7.9	11.4	9.0	8.1	8.0
Real Personal Disposable Income	-3.3	-0.3	4.6	1.3	1.7	1.4	6.5	1.3	1.4	1.4	3.0	1.6	2.7
Profits from Current Production ($B)[1]	197.5	196.2	177.2	182.3	188.4	196.8	206.2	209.1	209.5	189.0	197.2	186.2	208.5
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										736	769	836	910
Unified Outlays										937	990	1008	1069
Unified Deficit										-201	-221	-172	-159

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.
[2]Unified budget figures on a fiscal year basis. FY85 and FY86 data are actual.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the fourth quarter of 1986. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 10.8 percent during 1987 and 6.9 percent in 1988. The trade weighted exchange value of the dollar falls by 9.8 percent in 1987 and 1.0 percent in 1988. The federal minimum wage is not expected to increase.

enues have remained a relatively constant share of the national output. Revenues now account for 19.6% of GNP, compared to a 22-year average of 19.4%. However, beginning in the mid-1970s, we lost control of government spending, and its share of the national output began to rise significantly. Federal spending now stands at 24.5% of GNP compared to an average of 21.5%. The increase in the ratio of federal outlays to GNP reflects the fact that federal expenditures have been rising faster than GNP, while the resulting deficit reflects the fact that, with the exception of 1983, expenditures are rising faster than receipts. These data point clearly to the source of the deficit: excessive spending, and suggest that the cure should be a reduction in spending, not an increase in taxes.

Uncertainties Surrounding the Trade Picture

Although we anticipate a turnaround in the trade figures during the next two years, we believe that lack of improvement in this area is an important threat to the economy. One major problem is that economic growth in all our major trading partners is not expected to be higher than about 3% this year and next. However, our export sector faces other more pressing problems than a weak foreign demand. The lack of competitiveness of U.S. products is widely recognized. Unfortunately, however, while the buzzword in Washington these days is "international competitiveness," many of the tax policy changes that were made as part of the Tax Reform Act of 1986 will work to the detriment of our international competitiveness.

For example, the Tax Reform Act raised the capital gains tax rates. Through its impact on risk investment and the mobility of capital, higher capital gains tax rates will have a negative impact on innovation, technological advancement, and new business formation. American firms will find themselves at a disadvantage *vis-à-vis* competitors from Japan, West Germany, and South Korea, whose citizens are exempt from capital gains taxes. The Tax Reform Act repealed the Investment Tax Credit and reduced depreciation deductions, thus raising the cost of capital and increasing the tax bias against investment. Lower levels of investment mean lower productivity and higher costs for American products. The new corporate minimum tax treats a large portion of accelerated depreciation as a tax preference item. This effectively repeals the bulk of any economic development or international competitiveness benefits accruing to the U.S. economy as a result of the capital cost recovery system. The Act reduced the research and development tax credit rate from 25% to 20% and failed to make it permanent. And its separate foreign tax credit limitation and allocation provisions will raise taxes on the worldwide operations of U.S. firms, thus offsetting the effect of the lower corporate tax rate.

The Protectionist Threat

Protectionist legislation represents another policy risk to the U.S. economy. Protectionism is not only the wrong solution to the trade deficit, it is a dangerous and irresponsible reaction to the problems of the export sector. Protectionism encourages retaliation and trade wars. Protectionism *vis-à-vis* the indebted developing countries will impair their ability to increase exports, raise foreign exchange and repay their debts, threatening the international financial system. Protectionism increases domestic costs of imported inputs and consumer goods, exacerbating inflationary pressures. Moreover, protectionism does not save American jobs. The jobs that might be preserved in the protected industry are offset by job losses elsewhere in the economy. The solution to the trade conundrum is (1) to encourage our industrialized trading partners to increase their own domestic demand; (2) to work to reduce nontariff trade barriers which unfairly keep U.S. products out of certain markets; and (3) enact legislation that will improve the competitiveness of U.S. exports.

The Potential for Increased Inflation

Despite the fact that wage pressures remain moderate, the risks of a resurgence in inflation have recently increased. Although the relationship between the rate of growth in the money supply and nominal GNP is not the same now as it was in the past, the rate of increase in M1 that we have recently experienced is alarming. Between the end of October and the end of December, M1 increased by 25.3%. Given the fact that nonoil import prices are rising steadily, and oil prices have also risen, the prognosis is for a reacceleration in inflation which could be further exacerbated by the enactment of protectionist legislation.

* * *

This recovery, which began with above-average strength, was debunked almost every step of the way. First, it was not supposed to happen. Once it was clear that the recovery was underway, we were told that it would not last long. And now, its impending death is reported frequently. Despite this cynicism, however, the economy has continued to move forward and, if the majority of the forecasting profession can be believed, it is on its way to achieving record longevity. Admittedly, everything is not coming up roses; some traditional industries have not recovered and are not likely to do so. Despite the impressive increases in employment, the unemployment rate is not as low as we would like it to be and interest rates could also be lower. These are causes for concern, but we should remember that what we have done in this decade, in sharp contrast to the previous one, is that we have added a sense of stability and certainty to the economy.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Dec '86	242.5	242.4	239.3	[c]	1.3
Gross National Product ($B)	IV '86	4,260.6	4,240.7	4,087.7	0.5	4.2
Gross National Product (82$B)	IV '86	3,698.3	3,686.4	3,622.3	0.3	2.1
Money Supply (M1) ($B)	Dec '86	730.4	713.5	626.6	2.4	16.6
Money Supply (M2) ($B)	Dec '86	2,804.7	2,781.4	2,566.5	0.8	9.3
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Dec '86	2,863.8	2,806.5	2,705.0	2.0	5.9
Personal Consumption Expenditures (82$B)	Nov '86	2,432.7	2,423.8	2,377.1	0.4	2.3
Disposable Personal Income ($B)	Dec '86	3,019.1	2,993.6	2,913.4	0.9	3.6
Disposable Personal Income (82$)	Nov '86	2,594.9	2,598.7	2,560.3	-0.1	1.4
Personal Savings Rate (%)	Dec '86	1.8	2.9	4.1	-1.1[b]	-2.3[b]
Civilian Employment (millions)	Jan '87	111.0	110.6	109.0	0.4	1.9
Civilian Unemployment Rate (%)	Jan '87	6.7	6.7	6.8	0.0[b]	-0.1[b]
Average Hourly Earnings	Jan '87	$8.83	$8.82	$8.68	0.1	1.7
Consumer Price Index (All Urban, 67 = 100) [a]	Dec '86	331.1	330.8	327.4	0.2	1.1
Prime Interest Rate (%) Feb. 9, 1987	Feb '87	7.5	7.5	9.5	0.0[b]	-2.0[b]
Retail Sales ($B)	Jan '87	119.3	126.6	117.3	-5.8	1.7
SERVICES SECTOR						
Employment in Services (Millions)	Jan '87	76.7	76.4	74.2	0.4	3.4
Consumer Purchases of Service ($B)	Dec '86	1,483.0	1,480.3	1,406.0	0.2	5.5
Consumer Purchases of Service (82$B)	Nov '86	1,191.1	1,180.5	1,174.0	0.9	1.5
Domestic Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Nov '86	21.2	22.3	17.7	-4.9	19.8
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	III '86	240.4	227.7	229.2	5.6	4.9
Profits Tax Liability	III '86	104.4	99.0	95.8	5.5	9.0
Tax Liability as a Percent of Profits	III '86	43.4	43.4	41.8	0.0[b]	1.6[b]
After Tax	III '86	135.9	128.8	133.4	5.4	1.9
Net Cash Flow	III '86	384.3	374.9	382.8	2.5	2.5
Industrial Production (77 = 100)	Jan '87	126.6	126.0	123.6	0.5	0.9
Capacity Utilization Rate (Mfg.) (%)	Dec '86	80.3	79.9	80.2	0.4[b]	0.1[b]
New Housing Starts (thou. units)	Jan '87	1,806.0	1,808.0	2,004.0	-0.1	-9.9
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	IV '86	172.7	170.7	169.3	1.2	2.0
Unit Nonlabor Costs (nonfarm) (77 = 100)	IV '86	162.1	165.9	160.3	-2.3	1.1
Producer Price Indices (67 = 100) [d]						
Crude Materials	Jan '87	284.0	274.8	302.9	3.3	-6.2
Intermediate Goods	Jan '87	307.1	305.0	313.8	[c]	-2.1
Finished Goods	Jan '87	291.7	289.9	291.3	0.6	0.1
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	IV '86	380.7	370.8	368.2	2.7	3.4
Imports of Goods & Services ($B)	IV '86	494.3	479.7	473.6	3.0	4.4
Balance on Goods & Services ($B)	IV '86	-113.6	-108.9	-105.3	4.3	7.9
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Dec '86	186.1	182.2	173.6	2.1	7.2

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] Less than 0.1 percent
[d] Index number not seasonally adjusted, percent change seasonally adjusted